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C O N F I D E N T I A L SECTION 01 OF 03 PRAGUE 000546

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TAGS: EPET ENRG ECON PREL RU EZ
SUBJECT: CZECHS AGREE TO TALKS WITH RUSSIA ON ELIMINATING
INTERMEDIARIES IN OIL TRADE; DELIVERIES STILL LOW

REF: A. PRAGUE 447
¶B. MOSCOW 2262
¶C. PRAGUE 367
¶D. 2007 PRAGUE 1549
¶E. 2007 PRAGUE 206

Classified By: POLEC Counselor Charles O. Blaha; Reasons 1.4 b & d.

¶1. (C) Summary: Despite earlier reports to the contrary, Russian crude oil deliveries still have not returned to normal as of August 15, with estimates of the shortfall for August ranging between 10 to nearly 30 percent. Nevertheless, Czech officials continue to downplay the significance of the disruption and do not believe the cuts to be linked to Czech support for missile defense or to be otherwise politically motivated (ref a). The cuts are not unprecedented and have not yet been deep enough or lasted long enough to cause significant difficulties. Consequently, the Czechs continue to portray the disruption as a bigger problem for Russia, arguing that while it took them only 24 hours to arrange to replace the lost oil, it may take Russia years to regain its credibility as a reliable supplier. Nevertheless, the Czechs continue to be very concerned about their long terms energy security and especially the impact of Russian efforts to gain further ownership of energy assets in Central and Eastern Europe.

¶2. (C) Czech officials have accepted Russia's formal offer to negotiate on reducing or eliminating intermediaries in the oil trade (ref b) and are awaiting a reply from Russia on when and where to meet. One source reported that the Russians wanted an inter-governmental agreement that would require the Czechs to purchase annually (at a higher price) a minimum annual amount of oil, thus constraining the Czechs' ability to further diversify sources of supply. Another Czech official speculated that the move was an attempt to redistribute the profits from the oil trade to new Kremlin favorites or, less likely, a public relations move to demonstrate Russia's desire to at least appear willing to introduce increased transparency into the murky oil market. End Summary.

Russian Oil Deliveries Still Below Normal

¶3. (SBU) The flow of oil from Russia, although up significantly from July, has still not returned to normal levels, despite earlier suggestions to the contrary. Industry Ministry Oil and Gas Department Head Jan Zaplatilek told us August 8 that Russia had confirmed deliveries of 90 percent of the aggregate Czech request for August.

Confirmation on whether Russia would be able to deliver the remaining ten percent would come only in the second half of the month.

¶4. (C) Others have presented more pessimistic scenarios. MFA Energy Envoy Vaclav Bartuska reported August 11 that while the Russians had confirmed delivery of 90 percent of Shell and Unipetrol,s requests, the Russians had only confirmed 83,000 metric tons of Agip's request for 150,000 tons. What would actually be delivered might still be less. Consequently, the Czech Republic might have to again tap into its strategic reserve. (Note: Shell, Unipetrol -- majority owned by Polish PKL Orlen -- and Agip -- part of the Italian ENI group -- are the oil-processing firms active in the Czech Republic. End Note.)

¶5. (SBU) Industry Ministry spokesman Tomas Bartovsky told the press August 12 that the Russians had confirmed around 85 percent of the aggregate Czech request. However, CEO Jaroslav Pantucek of the state-owned oil pipeline operator MERO publicly estimated that the shortfall for August could be as great as 140,000 metric tons or a little less than 30 percent of the roughly 500,000 tons requested. For its part, Unipetrol told us that the Russians had confirmed delivery for most of its August request and that the company was receiving all that had been promised. Neither the Czech offices of Shell or Agip were willing to comment.

¶6. (C) Both Zaplatilek and Bartuska cautioned, however, that the Czech government had no knowledge of the details of Unipetrol, Shell, or Agip's contracts for Russian crude oil,

including how much had been contracted and at what price. Bartuska suspected that not even the Czech offices of these three companies had this information. Rather these details were carefully guarded by the purchasing office in the company,s home country, and the Czech branch was only informed about the schedule for upcoming deliveries.

¶7. (C) The expected August shortfall follows deliveries of under 60 percent of the aggregate Czech request of 540,000 metric tons in July and 85 percent of the more modest Czech request for June. As reported in ref a, the Czech Republic was able to make up quickly the shortfall by increasing deliveries through the Ingolstadt-Kralupy-Litvinov (IKL) link of the Trans-Alpine Pipeline (TAL) (which originates in Trieste and flows to Ingolstadt in Bavaria) and by tapping into its strategic reserve. According to Zaplatilek, the reserve now holds slightly less than a 90 day supply of domestic consumption.

¶8. (U) According to Ministry of Industry sources, the Czech Republic imported 7,186,300 metric tons of oil in 2007 (down from 7,865,000 metric tons in 2006), 64.6 percent of which came from Russia through the Druzhba pipeline. The remaining 35.4 percent came through Trieste and the TAL-IKL pipelines and originated mainly in Azerbaijan (27.4 percent), Kazakhstan (4.4 percent), Algeria (2.7 percent), and Libya (0.9 percent).

Czechs Doubt Political Motive for Cuts

¶9. (C) All our interlocutors continue to dismiss any political motivation for the cuts and do not believe that they are linked to the July 8 signing of the U.S.-Czech Ballistic Missile Defense Agreement. The Czechs appear inclined to accept the Russian explanations of problems with intermediaries at face value.

¶10. (C) Zaplatilek noted that the request for July from the three international oil companies was also for the largest amount ever requested, and that the Czech Republic had experienced similar disruptions in the supply of Russia oil during previous summers (ref a). The recent cuts were also not deep enough nor had they lasted long enough to cause any

significant problems. If the Russians had wanted to punish the Czech Republic, they would have cut deliveries of gas, not oil. (Note: The Czech Republic is dependent on Russia for roughly 70 percent of its gas supply and would find it more difficult to replace quickly any shortfalls. End note.) Bartuska stressed that the Czech government,s main talking point continued to be that the disruption was more a problem for Russia than the Czech Republic: it only took the Czech Republic 24 hours to arrange to replace the lost oil, while it may take Russia years to restore its credibility as a reliable partner.

¶11. (C) Nevertheless the Czechs were very pleased with the response from other EU member states, Bartuska added. Even Belgium had asked for suggestions on how the EU could punish Russia over this. Bartuska did not believe, however, that the situation could be used as a catalyst to forge a more coherent EU energy strategy or a common approach to Russia on energy issues.

¶12. (C) Bartuska also emphasized that unlike the gas market where RWE Transgas had a direct contract with Gazprom (ref d), the oil market lacked any transparency and consisted of several layers of intermediaries, each entitled to a cut. None of the three oil processors had contracts directly with their Russian suppliers. Rather the contracts were with various middle-men, who were incorporated in exotic locations such as the Cayman Islands or Cyprus. This system worked smoothly when things were going well and there was enough money flowing to "oil" the system. When things were not going well, such as the possible Russian explanations of problems with production or lack of tankers for transport, this system exacerbated problems.

Czechs Accept Russian Offer to Negotiate

¶13. (C) Our interlocutors also confirmed ref b report that the Czech Republic had accepted Russia's offer to negotiate on reducing or eliminating intermediaries in the oil market. According to Bartuska, the Czech Republic has received a

formal letter approved by Russian PM Putin proposing the talks. The Czechs replied that they wanted the negotiations to take place at the highest level possible. The Czechs were now waiting for Moscow to propose a time and place, as well as more details on what was expected from the Czech side.

¶14. (C) According to MFA Security Policy Director Veronika Kuchynova-Smigolova, the Russians want an inter-governmental agreement binding the Czechs to a minimum annual purchase at a higher price. Kuchynova-Smigolova dismissed this as an effort to lock the Czech Republic into a straight-jacket that would prevent it from further diversifying its sources of supply.

¶15. (C) Bartuska and Zaplatilek were less sure of Russian intentions. Both, however, were skeptical that Russia would eliminate all intermediaries, with Bartuska citing the Czech proverb that carp do not drain their own ponds. Both speculated that Russia's real interest might be a redistribution of profits in the oil trade in favor of new Kremlin favorites either by swapping intermediaries or by creating a new governmental clearing office.

¶16. (C) Bartuska also noted that the proposed talks might also be simply a Russian public relations ploy, designed to at least give an appearance of wanting to introduce more transparency into the oil trade. Bartuska doubted that the talks, which are not yet public, would produce any major change in Russian oil polices or practices. If the Russian government intended a major policy realignment, it would not start with negotiations with the Czech Republic, which for Russian oil is a very marginal market. Bartuska also said he had heard nothing that would suggest that Russia intends to use the talks as leverage to try to gain control of energy assets in the Czech Republic, something the Czech government

has consistently and strongly resisted in the past.

¶17. (C) Bartuska reported that the Czech government had already begun consultations with Unipetrol, Shell, and Agip in preparation for the talks. He suspected that they were not really interested in increased transparency as they also probably profited from the current murky system. This suspicion was reinforced when only Unipetrol bothered to show up at the first meeting.

Comment:

¶18. (C) The Czech government continues to portray the disruptions as nothing exceptional and has largely been able to make the cuts a non-story domestically. This could change, however, should the cuts become deeper or be likely to last significantly longer, something none of our interlocutors expect. Continued difficulties in Georgia or Turkey that would affect the Baku-Ceyhan pipeline long-term and thus the amount, type, and cost of oil available for delivery through TAL-IKL could also potentially exacerbate the situation.

¶19. (C) While the oil cuts are not seen as exceptional, the Czechs continue to be very concerned about their long-term energy security and Russian efforts to gain control of energy assets in central and Eastern Europe. They are currently trying to buy Exxon Mobil's shares in the TAL Pipeline consortium (ref c). Last year they intervened to prevent Lukoil from obtaining an ownership stake in Ceska Rafinerska (ref e) and are very concerned that the Slovak Government may sell Yukos,s former 49 percent share of Transpetrol to other Russian interests (ref c). Consequently, we have every expectation that the Czechs will work especially diligently within the EU Troika, and once they assume the EU Presidency, to advance EU discussion and action on energy issues. This will also be a priority for the Czechs during the September launch of the Strategic Dialogue with the United States.
Thompson-Jones